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IN THE

SUPREME COURT OF THE UNITED STATES

_____ Term 1965

I. L. VAN ZANDT AND RUTH B. VAN ZANDT,
Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

PETITION FOR WRIT OF CERTIORARI
TO
THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

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COMMISSIONER OF INTERNAL REVENUE,
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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Petitioners pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit entered in the above styled case on February 12, 1965.

CITATIONS TO OPINIONS BELOW

The opinion of the Tax Court of the United States (R. 53-67) printed in Appendix B hereto, *infra*, page 25-39, is reported in 40 T.C. 824. The opinion of the Court of Appeals printed in Appendix B hereto, *infra*, page 40-41, is reported in 341 F.2d 440. Judgment entered February 12, 1965 (R. 76) is printed in Appendix B, *infra*, page 49.

JURISDICTION

The judgment of the Court of Appeals was entered on February 12, 1965. Rehearing was not applied for. The jurisdiction of this Court is invoked under Title

28 U.S.C., Section 1254 and Title 26 U.S.C., Section 7482 (IRC 1954 Section 7482).

QUESTION PRESENTED

The question presented is:

Did payments by the trustor-trustee to two trusts for his children made by Dr. I. L. Van Zandt in 1958 and 1959 as and for rental of offices, laboratory facilities, etc., used in the practice of his profession, claimed as deductions in Petitioners' 1958 and 1959 income tax returns, qualify as "ordinary and necessary business expenses" under Section 162(a)(3) IRC 1954, as contended by petitioners, or was the Tax Court of the United States correct in its holding that such payments did not qualify as "ordinary and necessary" in denying their deduction from petitioners' taxable income for their taxable years 1958 and 1959?

STATUTES INVOLVED

The statutory provisions involved are Section 162 (a)(3) IRC 1954 and Sections 671 to 678 inclusive IRC 1954. They are printed in Appendix A *infra* pp. 11-24.

STATEMENT

By a statutory notice mailed to Petitioners on April 7, 1961 (R. 7-12) the Commissioner of Internal Revenue disallowed as deductions from income the rental payments involved in this proceeding and determined against Petitioners deficiencies in income tax for the calendar year 1958 and 1959 in the amounts of $1,-

698.57 for the calendar year 1958, and $2,679.95 for the calendar year 1959, or total deficiencies for the two said years of $4,378.52.

On June 8, 1961 Petitioners petitioned the Tax Court of the United States for a redetermination of the deficiencies set forth by the Commissioner of Internal Revenue in his said notice of deficiency (Service Symbols A:R:90-D-308) dated April 7, 1961. The case was submitted to the Tax Court upon a complete stipulation of facts, including copies of trust instruments, conveyances and leasing agreements attached thereto as exhibits (R. 21-47). On August 8, 1963 the Tax Court of the United States handed down its opinion and decision (R. 53-67) in which it sustained the Commissioner's denial of the rental deductions claimed by petitioners and, on the same day, viz, August 8, 1963, ordered and decided (R. 68) that there were deficiencies in income tax for the years 1958 and 1959 in the respective amounts of $1,698.57 and $2,679.95. Thereafter on November 4, 1963 taxpayers petitioned for a review of the judgment of the Tax Court in the United States Court of Appeals for the Fifth Circuit. (R. 68-75).

The Court below affirmed the order of the Tax Court of the United States upon the sole authority of *W. H. Armston Co., Inc. v. Commissioner of Internal Revenue*, 5 CIR, 188 F.2d 531, stating in its opinion that it regarded its holding as consistent with *Skemp v. Commissioner*, 7th CIR, 948, 168 F.2d 598 (R. 77-85), the leading case in the line of authorities relied on by Petitioners.

REASONS FOR GRANTING THE WRIT

The writ herein prayed for should be granted because:

(1) The opinion and decision below is in direct conflict (i) with the decision of the Circuit Court of Appeals for the seventh Circuit in *Skemp v. Commissioner* (1948); 168 F.2d 598[1] and (ii) with the decision of the United States Court of Appeals for the Third Circuit (1950) in *Brown v. Commissioner* 180 F.2d 926 and (iii) runs counter to the principles laid down in *White v. Fitzpatrick*, CCA 2nd (1951); 193 F.2d 398 to the effect that, within the context of Sections 23(a)(1)(A) and 22(a) of the Internal Revenue Code of 1939, the line to be drawn is the same and the same result should obtain whether the question arises under Section 22(a) (relating to gross income) or 23(a)(1)(A) (relating to deductions) of the Internal Revenue Code of 1939. The cited Sections of the Internal Revenue Code of 1939 were the forerunners and counterparts of Sections 61 and 62 respectively and Section 162 of the Internal Revenue Code of 1954.

(2) The opinion and decision below is directly contrary to principles spelled out in detail by the Congress in Sections 671 to 678 inclusive of the Internal Revenue Code of 1954.

(3) Clearly the question presented is of importance in the administration of the Federal Taxing Acts. Failure to grant this writ and to reverse the decision below will result in taxpayers residing in the Seventh and Third Circuits being allowed deductions from in-

[1]For convenience the opinion of the Court of Appeals (7th Cir.) in the Skemp case is printed as Appendix C, infra pp. ____.

come for a certain type of expenditure, whereas taxpayer residents of the Fifth Circuit who, under identical circumstances make like expenditures, will be denied the right to deduct the same from taxable income.

(4) Unless this writ be granted and the decision below reversed (i) the practical effect will be to tax the same income twice, once to the grantor and again to the trusts or their beneficiaries, a result not lightly to be countenanced and (ii) taxpayers whose accumulations (ie, wealth) are in the form of stocks, bonds or other investments unlimited amounts of which under the Internal Revenue Code of 1954 freely can be placed in trust for ten years or more for the benefit of their children and the revenue therefrom excluded from the taxable income of the grantor, would enjoy a distinct tax advantage in providing for the education and welfare of their children over individuals whose accumulations are tied up in assets which they employ in their business. It is not believed, and the structure and wording of Sections 671 to 678 IRC 1954 inclusive do not so indicate, that the Congress, by enacting those provisions of the Internal Revenue Code of 1954, intended to enact a "rich man's statute". An analysis of the carefully framed provisions of the cited Sections indicates a desire, purpose and intention on the part of the Congress (i) to liberalize then existing rules pertaining to the taxation of trusts and their grantors (which had grown up like topsy from a series of Court decisions in that area), (ii) to liberalize the provisions of the so-called "Clifford" regulations which themselves had attempted to liberalize Judge-made law in

this area which had crept into the Federal tax field, and (iii) to state its views and desires in controlling statutory language not subject to arbitrary change by executive whim or judicial construction.

ARGUMENT

Even a cursory review of the single authority cited and exclusively relied on by the Circuit Court below in its opinion and decision, viz, *W. H. Armston Co., Inc. v. Commissioner of Internal Revenue*, 5 CIR, 188 F.2d, 531, makes it clearly apparent that the *Armston* case does not touch top, side or bottom of the issue involved in the case at bar.

The facts in the *Armston* case were:

Katherine G. Armston, a housewife, owned more than 50% of the capital stock of W. H. Armston Co., Inc., a corporation engaged in construction work. Substantially all of the balance of the capital stock of that company was owned by Katherine's husband, W. H. Armston. Katherine worked as secretary for the corporation under the direction of her husband, receiving a salary of $2,000.00 per annum, which was her only source of income. At February 3, 1943 the corporation owned heavy construction equipment acquired by it in 1940, 1941 and 1942 at a cost of $84,354.94. Its surplus and undivided profits totaled approximately $278,000.00. The corporation had paid no dividends (other than a non-taxable stock dividend) since its organization. In the early part of February, 1943, Katherine Armston, pursuant to a plan devised and implemented by her husband, contracted to "purchase"

the aforementioned heavy equipment from the corporation for $30,000.00 (later increased to $33,667.36) which she borrowed from the corporation's bank, pledging her stock in Armston Company as security for the loan. A "rental" agreement was entered into between Katherine and the corporation under which for the three years, 1943, 1944 and 1945 she was paid "rentals" aggregating $168,130.70. In the first three or four months of the aforementioned rental agreement she was paid enough "rents" to repay the $30,000.00 borrowed to purchase the equipment.

At the time the rather complicated procedures required to effect the foregoing transactions were entered into, both Mrs. Armston and her husband knew that the rental payments contracted for would be sufficient to repay her bank loan in two or three months. All of the attendant circumstances considered, the Tax Court held (12 T.C. 539, page 550) that the alleged "purchase" and "rental payments" were, in effect, distributions of corporate earnings in the nature of cash dividends. One Tax Court Judge concurred in the result, but not the reasoning, of the majority opinion, and three Tax Court Judges dissented. The Court of Appeals for the Fifth Circuit affirmed, 186 F.2d 531.

Both the decision of the Tax Court and that of the Court of Appeals in the *Armston* case were based upon their respective findings that the purported sale and lease arrangement between W. H. Armston Co., Inc. and its majority stockholder, Katherine Armston, was without substance. In its opinion and judgment below the Court of Appeals for the Fifth Circuit conceded

that the facts in the case at bar were quite similar to those involved in *Skemp v. Commissioner*, 7 Cir., 168 F.2d 598, cited and relied on in taxpayers' brief in the Circuit Court. It noted, however, that the trusts in the *Skemp* case were created for twenty (20) years, the property upon termination of the trust was not to revert to the original donors, and there was a bank trustee. The statement was made in the opinion that "Furthermore, the property transferred contained considerably more space than was rented back to the Doctor for his use". Counsel has been unable to find a basis for this last statement in either the Tax Court decision or that of the Circuit Court in the *Skemp* case.

The differences noted were relevant only to the question whether the grantors in the *Skemp* case did or did not retain a sufficient bundle of rights in and to the trust assets that they might be considered to have remained the "owners" of such assets throughout the term of the trust. Had such been the case, and the payments in effect made by grantors to themselves, ipso facto no right to a deduction from income would have ensued.

Because of legislation enacted subsequent to the taxable years involved in the *Skemp* case (ie, Sections 671 to 678 inclusive, IRC 1954), the criteria used by the Court in the *Skemp* case to determine whether the grantors there remained "owners" of the assets transferred in trust (ie, absence of reversionary rights, a bank trustee, etc.) prior to the taxable years here involved had been superseded by new criteria incor-

porated into the statute itself and here applicable. We will not belabor this point further other than to point out that in its opinion in this proceeding the Circuit Court conceded (R. 84) that the trusts with which we are here concerned "met not only the minimum but all of the statutory tests so that its income will be taxed to it, not to the settlors". Implicit in the foregoing finding of the Circuit Court is the finding that by the trust instruments, the deeds of conveyance and bills of sale, and the lease agreements set out verbatim in the Record herein (R. 26-47), taxpayers, as required by the applicable controlling statutes, irrevocably divested themselves of an estate for a period of more than ten (10) years in the real property and equipment conveyed to the trusts, and any revenue therefrom, did not retain a prohibited degree of control over trusts assets, dealt fairly with the trusts and made binding agreements to pay to the trusts the rentals involved in this proceeding for the right to use in their business, the property premises and equipment conveyed to the trusts.

There can, therefore, be no question as to the duty of petitioner, I. L. Van Zandt, throughout the duration to the estate for years vested in the trusts to pay the rent specified in the leasing agreements. This brings us to the question whether the fact that taxpayers voluntarily created the situation which required such payments precludes the rental thus required to be paid from being deducted from taxpayers' income. *Skemp v. Commissioner*, 168 F.2d 598 p. 600, and *Brown v. Commissioner*, 180 F.2d 926, 929 expressly hold that the fact that a taxpayer voluntarily

places himself in a situation where he is obligated to make rental payments for the use of facilities needed and used in taxpayer's business does not preclude taxpayer from deducting the payments made as ordinary and necessary business expenses. In holding otherwise in the case at bar, the opinion and decision below is in direct conflict with the *Skemp* and *Brown* cases, *supra*, a conflict which should be resolved by this Court.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX A

INTERNAL REVENUE CODE OF 1954

SECTION 162. Trade or Business Expenses.

(a) In General.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

* * * * * * * *

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

Subpart E—Grantors and Others Treated as Substantial Owners

Sec. 671. Trust income, deductions, and credits attributable to grantors and others as substantial owners.
Sec. 672. Definitions and rules.
Sec. 673. Reversionary interests.
Sec. 674. Power to control beneficial enjoyment.
Sec. 675. Administrative powers.
Sec. 676. Power to revoke.
Sec. 677. Income for benefit of grantor.
Sec. 678. Person other than grantor treated as substantial owner.

SECTION 671. Trust Income, Deductions, and Credits Attributable to Grantors and Others as Substantial Owners.

Where it is specified in this subpart that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual. Any remaining portion of the trust shall be subject to subparts A through D. No items of a trust shall be included in computing the taxable income and credits of the grantor or of any other person solely on the grounds of his dominion and control over the trust under section 61 (relating to definition of gross income) or any other provision of this title, except as specified in this subpart.

SECTION 672. Definitions and Rules.

(a) Adverse Party.—For purposes of this subpart, the term "adverse party" means any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust. A person having a general power of appointment over the trust property shall be deemed to have a beneficial interest in the trust.

(b) Nonadverse Party.—For purposes of this subpart, the term "nonadverse party" means any person who is not an adverse party.

(c) Related or Subordinate Party.—For purposes

of this subpart, the term "related or subordinate party" means any nonadverse party who is—

(1) The grantor's spouse if living with the grantor;

(2) any one of the following: The grantor's father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; a subordinate employee of a corporation in which the grantor is an executive.

For purposes of sections 674 and 675, a related or subordinate party shall be presumed to be subservient to the grantor in respect of the exercise or nonexercise of the powers conferred on him unless such party is shown not to be subservient by a preponderance of the evidence.

(d) Rule Where Power Is Subject to Condition Precedent.—A person shall be considered to have a power described in this subpart even though the exercise of the power is subject to a precedent giving of notice or takes effect only on the expiration of a certain period after the exercise of the power.

SECTION 673. Reversionary Interests.

(a) General Rule.—The grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom if, as of the inception of that portion

of the trust, the interest will or may reasonably be expected to take effect in possession or enjoyment within 10 years commencing with the date of the transfer of that portion of the trust.

(b) Exception Where Income Is Payable to Charitable Beneficiaries.—Subsection (a) shall not apply to the extent that the income of a portion of a trust in which the grantor has a reversionary interest is, under the terms of the trust, irrevocably payable for a period of at least 2 years (commencing with the date of the transfer) to a designated beneficiary, which beneficiary is of a type described in section 170(b)(1)(A)(i), ~~(ii)~~, or (iii).

(c) Reversionary Interest Taking Effect at Death of Income Beneficiary.—The grantor shall not be treated under subsection (a) as the owner of any portion of a trust where his reversionary interest in such portion is not to take effect in possession or enjoyment until the death of the person or persons to whom the income therefrom is payable.

(d) Postponement of Date Specified for Reacquisition.—Any postponement of the date specified for the reacquisition of possession or enjoyment of the reversionary interest shall be treated as a new transfer in trust commencing with the date on which the postponement is effected and terminating with the date prescribed by the postponement. However, income for any period shall not be included in the income of the grantor by reason of the preceding sentence if such income would not be so includible in the absence of such postponement.

SECTION 674. Power to Control Beneficial Enjoyment.

(a) General Rule.—The grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval of consent of any adverse party.

(b) Exceptions for Certain Powers.—Subsection (a) shall not apply to the following powers regardless of by whom held:

(1) Power to apply income to support of a dependent.—A power described in section 677(b) to the extent that the grantor would not be subject to tax under that section.

(2) Power affecting beneficial enjoyment only after expiration of 10-year period.—A power, the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the expiration of a period such that a grantor would not be treated as the owner under section 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the expiration of the period unless the power is relinquished.

(3) Power exercisable only by will.—A power exercisable only by will, other than a power in the grantor to appoint by will the income of the trust where the income is accumulated for such disposition by the grantor or may be so accumu-

lated in the discretion of the grantor or a non-adverse party, or both, without the approval or consent of any adverse party.

(4) Power to allocate among charitable beneficiaries.—A power to determine the beneficial enjoyment of the corpus or the income therefrom if the corpus or income is irrevocably payable for a purpose specified in section 170(c) (relating to definition of charitable contributions).

(5) Power to distribute corpus.—A power to distribute corpus either—

(A) to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries) provided that the power is limited by a reasonably definite standard which is set forth in the trust instrument; or

(B) to or for any current income beneficiary, provided that the distribution of corpus must be chargeable against the proportionate share of corpus held in trust for the payment of income to the beneficiary as if the corpus constituted a separate trust.

A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children.

(6) Power to withold income temporarily.—

A power to distribute or apply income to or for any current income beneficiary or to accumulate the income for him, provided that any accumulated income must ultimately be payable—

(A) to the beneficiary from whom distribution or application is withheld, to his estate, or to his appointees (or persons named as alternate takers in default of appointment) provided that such beneficiary possesses a power of appointment which does not exclude from the class of possible appointees any person other than the beneficiary, his estate, his creditors, or the creditors of his estate, or

(B) on termination of the trust, or in conjunction with a distribution of corpus which is augmented by such accumulated income, to the current income beneficiaries in shares which have been irrevocably specified in the trust instrument.

Accumulated income shall be considered so payable although it is provided that if any beneficiary does not survive a date of distribution which could reasonably have been expected to occur within the beneficiary's lifetime, the share of the deceased beneficiary is to be paid to his appointees or to one or more designated alternate takers (other than the grantor or the grantor's estate) whose shares have been irrevocably specified. A power does not fall within the powers described in this paragraph if any person has a power to

add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus except where such action is to provide for after-born or after-adopted children.

(7) Power to withhold income during disability of a beneficiary.—A power exercisable only during—

(A) the existence of a legal disability of any current income beneficiary, or

(B) the period during which any income beneficiary shall be under the age of 21 years,

to distribute or apply income to or for such beneficiary or to accumulate and add the income to corpus. A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children.

(8) Power to allocate between corpus and income.—A power to allocate receipts and disbursements as between corpus and income, even though expressed in broad language.

(c) Exception for Certain Powers of Independent Trustees.—Subsection (a) shall not apply to a power solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of

whom is the grantor, and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor—

(1) to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries; or

(2) to pay out corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries).

A power does not fall within the powers described in this subsection if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children.

(d) Power to Allocate Income if Limited by a Standard.—Subsection (a) shall not apply to a power solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom is the grantor or spouse living with the grantor, to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries, whether or not the conditions of paragraph (6) or (7) of subsection (b) are satisfied, if such power is limited by a reasonably definite external standard which is set forth in the trust instrument. A power does not fall within the powers described in this subsection if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or

corpus except where such action is to provide for after-born or after-adopted children.

SECTION 675. Administrative Powers.

The grantor shall be treated as the owner of any portion of a trust in respect of which—

(1) Power to deal for less than adequate and full consideration.—A power exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party enables the grantor or any person to purchase, exchange, or otherwise deal with or dispose of the corpus or the income therefrom for less than an adequate consideration in money or money's worth.

(2) Power to borrow without adequate interest or security.—A power exercisable by the grantor or a nonadverse party, or both, enables the grantor to borrow the corpus or income, directly or indirectly, without adequate interest or without adequate security except where a trustee (other than the grantor) is authorized under a general lending power to make loans to any person without regard to interest or security.

(3) Borrowing of the trust funds.—The grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year. The preceding sentence shall not apply to a loan which provides for adequate interest and adequate security, if such loan is

made by a trustee other than the grantor and other than a related or subordinate trustee subservient to the grantor.

(4) General powers of administration.—A power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. For purposes of this paragraph, the term "power of administration" means any one or more of the following powers: (A) a power to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; (B) a power to control the investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; or (C) a power to reacquire the trust corpus by substituting other property of an equivalent value.

SECTION 676. Power to Revoke.

(a) General Rule.—The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under any other provision of this part, where at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a nonadverse party, or both.

(b) Power Affecting Beneficial Enjoyment Only After Expiration of 10-Year Period.—Subsection (a) shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the expiration of a period such that a grantor would not be treated as the owner under section 673 if the power were a reversionary interest. But the grantor may be treated as the owner after the expiration of such period unless the power is relinquished.

SECTION 677. Income for Benefit of Grantor.

(a) General Rule.—The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be—

(1) distributed to the grantor;

(2) held or accumulated for future distribution to the grantor; or

(3) applied to the payment of premiums on policies of insurance on the life of the grantor (except policies of insurance irrevocably payable for a purpose specified in section 170(c) (relating to definition of charitable contributions)).

This subsection shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the expiration of a period such that the grantor would not be

treated as the owner under section 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the expiration of the period unless the power is relinquished.

(b) Obligations of Support.—Income of a trust shall not be considered taxable to the grantor under subsection (a) or any other provision of this chapter merely because such income in the discretion of another person, the trustee, or the grantor acting as trustee or co-trustee, may be applied or distributed for the support or maintenance of a beneficiary whom the grantor is legally obligated to support or maintain, except to the extent that such income is so applied or distributed. In cases where the amounts so applied or distributed are paid out of corpus or out of other than income for the taxable year, such amounts shall be considered to be an amount paid or credited within the meaning of paragraph (2) of section 661 (a) and shall be taxed to the grantor under section 662.

SECTION 678. Person Other Than Grantor Treated as Substantial Owner.

(a) General Rule.—A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:

(1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or

(2) such person has previously partially released or otherwise modified such a power and

after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.

(b) Exception Where Grantor Is Taxable.—Subsection (a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust is otherwise treated as the owner under sections 671 to 677, inclusive.

(c) Obligations of Support.—Subsection (a) shall not apply to a power which enables such person, in the capacity of trustee or co-trustee, merely to apply the income of the trust to the support or maintenance of a person whom the holder of the power is obligated to support or maintain except to the extent that such income is so applied. In cases where the amounts so applied or distributed are paid out of corpus or out of other than income of the taxable year, such amounts shall be considered to be an amount paid or credited within the meaning of paragraph (2) of section 661 (a) and shall be taxed to the holder of the power under section 662.

(d) Effect of Renunciation or Disclaimer.—Subsection (a) shall not apply with respect to a power which has been renounced or disclaimed within a reasonable time after the holder of the power first became aware of its existence.

APPENDIX B

DECISIONS BELOW

OPINION OF COURT
40 T. C. No. 87

TAX COURT OF THE UNITED STATES

I. L. VAN ZANDT AND RUTH B. VAN ZANDT, Petitioners, v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 92670 Filed August 8, 1963

Petitioner, a physician, owned a building and certain equipment which he used in his medical practice. He created two 10-year irrevocable trusts under sec. 673, I.R.C. 1954, for the benefit of his son and daughter, naming himself as trustee. Petitioner then conveyed the real property by deed and transferred the equipment by bill of sale to the trusts. On the same day he, as trustee, leased the building and equipment back to himself for continued use in practicing his profession. He deducted the rental payments made to the trusts in 1958 and 1959. *Held*, that such rental payments are not deductible as ordinary and necessary business expenses under sec. 162 (a) (3).

R. B. Cannon for the petitioners.

Williard A. Herbert for the respondent.

OPINION

DAWSON, *JUDGE:* Respondent determined deficiencies in the income tax of petitioners for the years 1958 and 1959 in the respective amounts of $1,698.57 and $2,679.95. The only issue presented is whether payments made during 1958 and 1959 by petitioner, I. L. Van Zandt, to two trusts as rental for a building and certain medical equipment, which he had previously transferred to the trusts and leased back for his use in the practice of medicine, are deductible as ordinary and necessary business expenses under the provisions of section 162(a)(3).[1]

All of the facts have been stipulated by the parties. The stipulation of facts and exhibits attached thereto are incorporated herein by reference.

I. L. Van Zandt and Ruth B. Van Zandt (hereinafter called petitioners) are husband and wife residing in Fort Worth, Tarrant County, Texas. Throughout the calendar years 1958 and 1959, and prior and subsequent thereto, I. L. Van Zandt (hereinafter sometimes referred to as petitioner) was engaged in the practice of medicine, specializing in surgery, at 905 and 915 Fifth Avenue in Fort Worth.

Petitioner's professional books and records are kept on a calendar year and cash basis. He and his wife filed their joint income tax returns on the same basis for 1958 and 1959 with the district director of internal revenue at Dallas, Texas.

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[1] All Code references in this opinion are to the Internal Revenue Code of 1954.

In the practice of his profession the petitioner, among other facilities, uses offices, a reception room, a laboratory, X-ray, and other equipment.

On April 29, 1957, the petitioners signed a single instrument creating two separate and distinct trusts. One, styled the NEIL VAN ZANDT TRUST, was for the benefit of their son, Neil Van Zandt, and the other, styled the EUGENIA VAN ZANDT TRUST, was for the benefit of their daughter, Eugenia Van Zandt. The trust instrument provides as follows:

> That we, I. L. VAN ZANDT and wife, RUTH BODDEKER VAN ZANDT, of the state and county aforesaid (who, in their capacity as grantors, will sometimes hereinafter be styled 'trustors') for the purpose of establishing the trusts hereinafter set up, and in consideration of the love and affection which we, and each of us, bear for our children, the beneficiaries of said trusts, have transferred, assigned and paid over and do hereby transfer, assign and pay over unto I. L. Van Zandt in his capacity as the original trustee of the trusts herein set up the sum of $200.00 in cash which shall constitute the aggregate original corpora of the two trusts herein created. And the said I. L. Van Zandt, as such trustee, hereby acknowledges the receipt of said sum and hereby declares that he shall, and that his successor or successors will, hold said sum and all revenues, additions and changes in the corpora of the two trusts herein created in trust for the use and purposes and upon the terms and conditions

hereinafter set forth and for the benefit of those hereinafter specified. That is to say:

ARTICLE ONE

The trustors intend to and do create hereby two separate and distinct trusts. One of these trusts is for the use and benefit of their son, Neil Van Zandt, born June 10, 1945. This trust shall be known as the Neil Van Zandt Trust. The other trust is for the use and benefit of their daughter, Eugenia Van Zandt, born August 10, 1946. This trust shall be known as the Eugenia Van Zandt Trust. One-half of the sum of $200.00 so paid by grantors to the trustee as hereinabove provided shall constitute the original corpus of each of said trusts. The separate identity of each of said trusts shall always be maintained by the trustee in the trustee's books, records, and accounting and in all other ways and for all other purposes.

ARTICLE TWO

Each trust hereby created shall continue until June 30, 1967, save and except that the prior death of its beneficiary shall terminate the trust. If a trust created hereby is terminated by the death of its beneficiary, any undistributed income of the trust then on hand shall be disposed of as provided in the deceased beneficiary's Will should such beneficiary leave a valid Will failing which such undistributed income shall pass to and vest in those persons entitled to the same under the laws of descent and distribution of the State of

Texas then in force and effect. Unless sooner terminated by the death of its beneficiary, each trust created hereby shall, as hereinabove set out, terminate June 30, 1967. Any and all undistributed income of the trust then on hand shall be distributed to the beneficiary of the trust, and the trust corpus shall pass to and revest in grantors.

ARTICLE THREE

During the minority of the beneficiary of a trust created hereby the income of that trust shall be accumulated by the trustee for the benefit of such beneficiary except that if during such period of minority neither of the trustors is financially able to provide for the care, support, maintenance and education of such beneficiary, so much of the income of that beneficiary's trust as the trustee deems appropriate may be expended to provide such care, maintenance, education and support. After the beneficiary of a trust created hereby reaches the age of twenty-one, there shall be distributed to such beneficiary periodically and as often as once each year all of the net income of that beneficiary's trust received after such beneficiary reaches the age of twenty-one years. Should the trustee determine such action to be for the best interest of the beneficiary, after the beneficiary attains the age of twenty-one years, there may be distributed to the beneficiary for the furtherance of his or her education, for the purpose of applying on the purchase

of a home should the beneficiary be then married, and for such other purposes as, in the sole discretion of the trustee, may appear to be for the best interest of the beneficiary, part or all of the income of the trust that accumulated during the minority of the beneficiary.

ARTICLE FOUR

Except as otherwise expressly provided herein, each trust created hereby shall be governed, controlled and administered under and in accordance with the terms of the Texas Trust Act as it may exist as of the time any determination is made or required to be made under this instrument. For so long as the original trustee, I. L. Van Zandt, is the trustee of the trusts created hereby, there shall be no restriction as to the character of investments which he may make of trust funds or of the business activities in which he may engage on behalf of the said trusts or either of them, save and except that no funds of the trusts, or either of them, may be loaned to trustors or either of them without adequate security or at less than the rate of interest then currently being charged on commercial loans by representative banks, members of the Fort Worth Clearing House Association, nor may the trustee purchase trust assets or, himself, lease or otherwise occupy trust property for less than the fair market value of such assets or right of occupancy. When the original trustee is no longer serving as such, any successor trustee may continue to hold, so

long as he or it may deem appropriate, any holding or investment on hand at the time the original trustee ceases to be such, but in making new investments and reinvestments, such successor trustee shall be limited to investments of the character which are then lawful investments of trust funds under the provisions of the Texas Trust Act as it may exist at the time such investment or reinvestment is made.

ARTICLE FIVE

No bond or security shall be required of the original or the first successor trustee herein provided for. When and if there are successor co-trustees, neither shall be liable for the misconduct or default of the other. Successor co-trustees may delegate to each other such ministerial duties in connection with said trusts as they may deem appropriate, including keeping of books and records and the safekeeping of property or securities.

The trustee (which term shall include a successor trustee or trustees, whether one or more, currently acting) shall always maintain complete and adequate books and records with respect to each trust. These books and records shall be open at all reasonable times to inspection by any party at interest or their duly authorized agents. After the beneficiary of a trust reaches the age of twenty-one, such books and records shall similarly be open to inspection by such beneficiary or

such beneficiary's duly authorized agent and such adult beneficiary shall be furnished annually a statement showing the condition of his or her trust and the results of its operations since the last preceding statement.

The trustee may accept from trustors, or either of them, or from any one else any addition or gift, whether testamentary or inter vivos, if the trustee deems it to be for the best interest of the receiving trust and its beneficiary to accept such addition or gift, but the trustee shall never be required to accept any addition or gift considered burdensome or not for the best interest of said trust and its beneficiary.

ARTICLE SIX

No beneficiary of a trust created hereby shall ever have or acquire the right or power in any wise to mortgage, pledge, anticipate, assign or convey his or her interest in a trust created hereby or the income therefrom nor shall the corpus or income of any trust created hereby ever be or become liable for any debt, demand or claim, including claims sounding intort [sic] or in the nature of alimony due by or asserted against such beneficiary or liable to seizure, sale or any other process to secure or satisfy any such asserted debt, claim or demand. Whenever and as often as the trustee deems it appropriate in order to carry out the spirit and purpose of this provision, in lieu of paying over to a beneficiary distributions of income otherwise permissible here-

under or directed in this instrument, the trustee himself may expend for the support, maintenance, education, welfare or happiness of such beneficiary all or part of the amount that otherwise would be distributed to the beneficiary. Distribution of income for minor beneficiaries may be made in whole or in part either directly to the minor beneficiary or to the parent or legal guardian of such minor beneficiaries, or may be expended for the maintenance, support, care, education, welfare or happiness of such minor beneficiaries.

ARTICLE SEVEN

If, during the existence of a trust created hereby, the original trustee dies, becomes incapacitated, resigns or is removed from the trusteeship of such trust, then The Fort Worth National Bank of Fort Worth, Texas, shall become the sole successor trustee of the trust or trusts as to which such vacancy exists. It is the intention of trustors that each trust created hereby shall always have the same trustee or co-trustee and if the trusteeship of any trust created hereby becomes vacant for any reason this fact shall ipso facto create a similar vacancy in the trusteeship of the other trust created hereby.

No trust created hereby shall ever fail for want of a trustee, and if a vacancy in trusteeship occurs which is not herein provided for, the vacancy shall be filled by a District Court of Tarrant County, Texas, upon the application of any party

at interest, but in exercising this power of appointment the appointing court shall appoint only a state or national bank subject to Federal or State supervision doing business in Texas, authorized to accept and effect trusts, and having at the time of its appointment as disclosed by its last official statement published prior thereto unimpaired capital and surplus of $1,000,000 or more.

As used herein, unless the context plainly requires a different meaning, the term trustee shall mean and include whomsoever whether one or more is or are acting as trustee or co-trustees hereunder.

ARTICLE EIGHT

The trustee shall, in addition to reasonable compensation for his or its services as such, be entitled to employ and compensate from trust funds all necessary agents, employees and attorneys and to indemnification and reimbursement from trust funds for all liabilities properly incurred as such trustee. The trustee shall always be entitled to the advice of counsel and to rely upon the advice of counsel selected and retained with reasonable care. No trustee shall ever be liable for mistakes in judgment or otherwise than for his negligence or breach of trust.

ARTICLE NINE

The trustors and each of them acknowledge and declare that the gift evidenced hereby and

the trusts hereby created are and are intended to be irrevocable insofar as any power of grantors to revoke is concerned, and that the same shall endure until terminated in the manner specified in this trust instrument and that this decision has been reached after full and mature consideration.

On May 23, 1957, the petitioners executed and delivered to I. L. Van Zandt, Trustee of the Neil Van Zandt and the Eugenia Van Zandt Trusts, a document transferring the real property, including improvements, located at 905 and 915 Fifth Avenue, Fort Worth, Texas, and on the same day I. L. Van Zandt, individually, executed and delivered to I. L. Van Zandt, Trustee of the Neil Van Zandt and the Eugenia Van Zandt Trusts, a document styled "Bill of Sale", pertaining to X-ray and other equipment.

Also on May 23, 1957, two documents, each styled "Lease," one covering the premises and improvements located at 905 and 915 Fifth Avenue, Fort Worth, and the other covering certain X-ray equipment and other equipment located in and on the aforesaid premises were executed by the Neil Van Zandt Trust and the Eugenia Van Zandt Trust to I. L. Van Zandt individually.

During the years 1958 and 1959 the premises at 905 and 915 Fifth Avenue, consisting of offices, reception room, laboratory, and equipment, were occupied and used by petitioner in his practice of medicine.

The amounts and considerations (i.e., agreements to pay ad valorem taxes, to maintain, etc.) recited as "Rents" or "Rental" in the leases, did not exceed reasonable rental for such property.

The petitioner paid to or for the Neil Van Zandt Trust and the Eugenia Van Zandt Trust jointly the sums of $4,800 during the calendar year 1958 and $6,304.30 during the calendar year 1959. The sum of $4,800 so paid in 1958 was based on the item of cash rental specified in the leases; and the amount of $6,304.30 paid in 1959 represented the cash rental of $5,200 provided for by the leases and the sum of $305.60 for "repairs" and $798.70 for "insurance" on the property, premises, and equipment described therein.

Respondent, treating petitioners' claimed rental expense deductions for the calendar years 1958 and 1959 as being composed of the separate items entering into the computation of the amounts deducted as rent in their returns for those years, disallowed $4,800 of the amount claimed for 1958 and $5,200 of the amount claimed for 1959 because he determined that the office building and medical equipment were petitioner's properties and, consequently, no deduction for rentals with respect thereto was allowable. In lieu thereof, respondent allowed petitioners a depreciation deduction for each of the calendar years 1958 and 1959 with respect to the office building and improvements and X-ray equipment involved.

Respondent disallowed that portion of petitioners rental deduction for the calendar year 1959 based on

"repairs" in the amount of $305.60 because respondent determined that the cost of a new roof was a nondeductible capital expenditure. He has allowed petitioners a depreciation deduction for the calendar year 1959 in the amount of $15.28 on this capitalized item.

Before us is the narrow question of rental deductions, and not *to whom* trust income is taxable. Petitioner contends that the rental payments he made to the trusts during 1958 and 1959 fall squarely within the provisions of section 162(a)(3)[2] and, therefore, are deductible as ordinary and necessary expenses paid in carrying on his medical practice. He relies on four decisions: *Skemp v. Commissioner*, 168 F.2d 598 (C.A. 7, 1948), reversing 8 T.C. 415 (1947); *Brown v. Commissioner*, 180 F.2d 926 (C.A. 3, 1950), reversing 12 T.C. 1095 (1949); *Albert T. Felix*, 21 T.C. 803 (1954); and *John T. Potter*, 27 T.C. 214 (1956).

The *Potter* case is clearly distinguishable because there the principal question was "whether the royalties petitioner agreed to pay were excessive." We held they were not.

In the *Skemp*, *Brown*, and *Felix* cases the independence of the trustee was the determinative factor. But here there is no independent trustee. Complete control over these trusts is in the hands of petitioner, who is

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[2] SEC. 162 TRADE OR BUSINESS EXPENSES.

(a) In General.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

the sole trustee and will continue as such until he dies, becomes incapacitated, resigns, or is removed. For this reason, if for no other, petitioner has failed to bring himself within the ambit of these three decisions. Cf. *Ingle Coal Corporation v. Commissioner*, 174 F.2d 569 (C.A. 7, 1949), affirming 10 T.C. 1199 (1948) where the transfer of property was not to an independent third party.

Moreover, it is well recognized that intra-family transactions resulting in the distribution of income within a family unit are subject to the closest scrutiny. *Helvering v. Clifford*, 309 U.S. 331 (1940); *Commissioner v. Tower*, 327 U.S. 280 (1946). Where, as here, the trusts and lease-backs are steps in a prearranged transaction, we think it is necessary to examine the true nature of the transaction and aim our inquiry at seeing if the *net effect* has been a shift of family income. Clearly, the effect of this transaction, while valid, was to cause a shift of family income and thus subvert the intended coverage of the statute. It would seem that economic reality, rather than the validity of the documents creating the trusts, the transfers and the leases, must serve as the basis upon which the right to the deduction rests.

To hold for the petitioner would be inconsistent with another line of decisions. Where a sale and lease-back does not serve a utilitarian business purpose, but is in reality a camouflaged assignment of income, the expenses have not been considered "ordinary and necessary." See *W. H. Armston Co. Inc. v. Commissioner*, 188 F.2d 531 (C.A. 5, 1951), affirming 12 T.C. 539

(1949); *Unger v. Campbell*, 7 A. F. T. R. 2d 547 (N.D.Tex. 1960); and *White v. Fitzpatrick*, 193 F.2d 398 (C.A. 2, 1951), certiorari denied 343 U.S. 928. The same result has been reached where the transfer was in the form of a gift. *Johnson v. Commissioner*, 86 F.2d 710 (C.A. 2, 1936), affirming 33 B.T.A. 1003 (1936). Since deductions are matters of legislative grace and the taxpayer has the burden of proving he is entitled to them, the petitioner here must establish that the rental payments were in fact "ordinary and necessary" expenses in his medical practice. While they may be ordinary, were they necessary under these circumstances? We think not. The petitioner owned and used the building and medical equipment in his "trade or business" before he ever created the trusts, transferred the property to the trusts, and then leased it back. Actually he continued to use the property in exactly the same manner as he had before these transactions were arranged and carried out. This indicates a lack of any business purpose, which we believe is implicity required by section 162(a). See *Gregory v. Helvering*, 293 U.S. 465 (1935); *W. H. Armston Co. Inc. v. Commissioner, supra; Unger v. Campbell, supra;* and *Hall v. United States*, 208 F. Supp. 584 (N.D. N.Y. 1962).

Accordingly, we conclude that the rental payments are not deductible as ordinary and necessary business expenses.

Decision will be entered for the respondent.

IN THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 21233

I. L. VAN ZANDT and RUTH B. VAN ZANDT,
Petitioners,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petition for Review of Decision of the Tax Court of the United States (District of Texas).

(February 12, 1965.)

Before TUTTLE, Chief Judge, BROWN and GEWIN, Circuit Judges.

TUTTLE, Chief Judge: The taxpayers, Dr. Van Zandt and his wife who filed joint income tax returns for the years 1958 and 1959, seek a review of a decision of the Tax Court which denied them the right to deduct from their gross income for the two years in question amounts paid them as rent on the doctor's offices to two trusts set up by the taxpayers for the benefit of their two children. The facts are stipulated.

On April 29, 1957, Dr. Van Zandt was engaged in the practice of medicine in Fort Worth, Texas, specializing in surgery. In the practice of his profession, among other facilities, he used offices, a reception

room, a laboratory, and X-ray and other equipment. On that date Dr. Van Zandt and his wife, by a single instrument, created two separate trusts naming Dr. Van Zandt as Trustee of each trust. One of these trusts was for the benefit of their son, the other for the benefit of their daughter. Each trust was made irrevocable for a term of ten years and two months. The trust instruments also contained the minimum requirements under the pertinent federal statutes which would prevent income of the trusts from being the income of the donors. Section 671 to 678, inclusive, Int. Rev. Code 1954.

On May 23, 1957, the Van Zandts executed and delivered to Dr. Van Zandt, Trustee of the two trusts, a deed to property located at 905 and 915 Fifth Avenue, Fort Worth, Texas, which was the property then occupied by Dr. Van Zandt for his office. On the same date, Dr. Van Zandt executed and delivered to himself as Trustee of the two trusts a bill of sale of X-ray and other equipment which he was then using in the practice of his profession. Simultaneously therewith, Dr. Van Zandt as Trustee of the two trusts executed two lease agreements under which he leased back to Van Zandt individually for his use in the practice of his profession, the building that he had just conveyed to himself as Trustee and the equipment as to which he had just received a bill of sale. For the two calendar years in issue, Dr. Van Zandt continued to use the premises in the practice of his profession and he paid to himself as Trustee of the two trusts, the sum of $4800 for the first year and of $6204.30 for the second year as "rent", "repairs" and "insurance."

The Van Zandts deducted the payments thus made to the trusts from the gross receipts of Dr. Van Zandt from the practice of his profession, claiming the same as ordinary and necessary business expenses.

The *effect* of these simultaneous actions is apparent to any tax practitioner and, in fact to any taxpayer who is conscious of the high rates of federal income taxation who has given the slightest thought to available methods of reducing the impact of income tax imposed by the Federal Government. However, in determining whether the Tax Court correctly held that these deductions could not be recognized, the fact that it has a salutary effect for the taxpayer is not of prime consideration. There is no principle of law that has been more clearly established than that a taxpayer may avail himself of all provisions established by the statutes for minimizing his taxes. The effect, however, does become of some significance when, as viewed by the Tax Court, and as we must view it, a payment between two closely related individuals can be explained *only* because of the salutary effect it has on the affairs of one of the two parties.

The attack here made by the Commissioner, and accepted by the Tax Court as correct, is that deductions from gross income are fixed by statute; the statute here invoked is that which permits a deduction as a trade or business expense for rentals; and this conveyance and lease-back did not create an obligation to pay rent that was "necessary."

The relevant provision is contained in Section 162 (a) (3) of the Internal Revenue Code of 1954, provid-

ing that "there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including . . . (3) rentals or other payments required to be made as a condition to the continued use or possession, for the purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

The thrust of the taxpayer's contention is that, once he had conveyed this building to the trust, which he had a legal right to do, the only way that he could remain as a tenant in the building was to pay rent for occupancy; that the rent paid by him was reasonable (and this is not disputed by the Government) and that the rental payments thus met all of the requirements of "ordinary and necessary expenses."

The Government, on the other hand, takes the position that as of the moment on May 23, 1957, prior to the execution of the lease for this premises, which created the obligation on the part of the doctor to pay rent, he owned the property outright; that he was under no obligation and therefore no necessity to pay rent for the "continued use or possession" of the property; that he then and there decided to effect a tax saving by simultaneously executing two documents, the first to place title to the property in himself as Trustee, and the second to lease it back to himself as tenant; that in determining whether these payments were "ordinary and necessary expenses" the acts must be viewed as a whole, that is the conveyance and lease-

back, rather than having them fragmented and viewing the expenses required to be paid under the lease without reference to the simultaneous act of conveying his property to the trusts that necessitated such a lease.

Taxpayers argue that once it is established that the trusts were "independent" within the contemplation of the appropriate sections of the Internal Revenue Statutes, dealings by them with the Trustee of the trusts should be assumed to be at arm's length so long as they were not distorted in amounts such as payments in excess of the fair rental value. The principal case relied upon by taxpayers is the *Skemp v. Commissioner*, 7 Cir., 168 F.2d 598. In that case, the facts were quite similar to those before us with the exception that the trusts there were created for twenty years and the property, upon termination of the trusts, was not to revert to the original donors, and to the further exception that there was a bank trustee. Furthermore, the property transferred contained considerably more space than was rented back to the doctor for his use. Thus, there may have been a proper business purpose of conveying the property to the trustees for management and payment of income to the beneficiaries, since the whole income did not come from the grantor. The Court of Appeals for the Seventh Circuit reversed the determination by the Tax Court that held, as it did here, that the rent paid by the doctor for his office in the building which he had previously owned was not deductible as ordinary and necessary business expense. That Court declined to consider the conveyance of the building and the lease-

back as a whole in determining whether the rent payments were ordinary and necessary.

The Government, on the other hand, relies heavily on a decision by this Court in *W. H. Armston Company v. Commissioner of Internal Revenue*, 5 Cir. 188 F.2d 531, which we think is directly in point with respect to whether the payment of rent to oneself or to one's alter ego is to be considered separately from a transfer of the rent producing property which takes place as part of a single transaction. In the *Armston* case, this Court held that where a wholly owned corporation 'sold' heavy equipment needed by the company in a contracting business to the wife of the principal stockholder and, at the same time, took a lease-back from her so that the company could continue to have the use of the equipment in its business, the substantial rental payments made by the company to the wife were not deductible as ordinary and necessary business expenses. The Court there said, "The evidence here conclusively reveals that the company's right to use the equipment supposedly sold to Catherine Armston was in nowise affected by the alleged transfer of title. The only logical motive and purpose of the arrangement under consideration was the creation of 'rentals,' which would form the basis for a substantial tax deduction, and thereby reduce the company's income and excess profits taxes from the year 1943. It was merely a device for minimizing tax liability, with no legitimate business purpose, and must therefore be disregarded for tax purposes, 188 F.2d 531, 533."

In view of the fact that at the very moment that the property here was conveyed to the trustee, the trustee became obligated to convey it back under lease to the original transferor, it seems clear that we do not have the normal relationship that exists when an "independent" trust is created, and recognized fully for tax purposes, because the trustee of such trusts is required to handle the affairs of the trust under the strict principles of a fiduciary in the management of the property. Here, with respect to the only asset, the trustee had nothing whatever to do in the management of the trusts, except to receive the income which had been predetermined. The whole principal amount of the trust was irrevocably the trust as created. Thus, it seems to us inevitably committed to the possession of the grantor the moment we must look at the original conveyance of the property together with the execution of the lease-back as a single transaction. Thus viewing it, we conclude that the *obligation* to pay rent resulted not as an ordinary and necessary incident in the conduct of the business, but was in fact created solely for the purpose of permitting a division of the taxpayer's income tax. Rent paid to discharge an obligation so created is itself not an ordinary and necessary business expense. *W. H. Armston Co. v. Commissioner, supra.*

Neither this decision nor Armston condemns outright and absolutely all transfers of property (and normal income tax incidents) as between a taxpayer and closely related parties such as corporation-stockholder, corporation-officer, corporation-director (and

vice versa) or individuals and genuine trusts, partnerships, etc., which result in economic benefit and income tax advantages. As Armston phrased it, the ". . . principal question is whether" the sale and lease-back ". . . should be disregarded as a subterfuge for income tax purposes." 188 F.2d 531, 532. In answering that question, the Court then proceeded to tick off a number of factors which proved conclusively that there was no good business purpose for the transaction.

Whether viewed as a single or a multi-step transaction, the same is true here. Although the question is not before us, we recognize that from the standpoint of taxability of income of the trust, not deductions which a payor of that "income" may take, this was a perfectly valid trust. It met not only the minimum but all of the statutory tests so that its income will be taxed to it, not the settlors. Nonetheless, the fact remains that there was no real business purpose served by this intricate transaction. The only thing accomplished was to funnel family income to children in a way that allowed a deduction to the payor and taxation to the recipients at reduced rates. Of course, as we have stated, tax advantages are not outlawed. And frequently it is the impact of taxes which alone makes the trade an economically feasible one.

As we should be careful lest our ruling circumscribe the flexibility which the law—even income tax law—accords to businessmen in determining what is good business purpose, we emphasize the proposition that the result ultimately depends on the factual evaluation of the particular case. Here, factors such as the short

term of the trust, reversion to the settlors, predetermination of the right to possession of the property, and the like, while perfectly permissible so far as taxability of the trust and the settlors goes, bear heavily on the element of business purpose. In this light, and the significant differences we point out here, we regard our holding as consistent with *Skemp v. Commissioner*, 7 Cir., 1948, 168 F.2d 598.

The judgment of the Tax Court is AFFIRMED.

IN THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH DISTRICT

October Term, 1964

No. 21233

D. C. Docket No. 92670

I. L. VAN ZANDT and RUTH B. VAN ZANDT,
Petitioners,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petition for Review of Decision of the Tax Court of the United States (District of Texas)

Before TUTTLE, Chief Judge, BROWN and GEWIN, Circuit Judges.

JUDGMENT

This cause came on to be heard on the petition of I. L. Van Zandt and Ruth B. Van Zandt, for review of a decision of the Tax Court of the United States, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered, adjudged and decreed by this Court that the decision of the Tax Court in this cause be, and the same is hereby, affirmed.

February 12, 1965

Issued as Mandate: March 9, 1965.

APPENDIX C

SKEMP v. COMMISSIONER OF INTERNAL REVENUE

No. 9424

Circuit Court of Appeals, Seventh Circuit,
June 8, 1948.

INTERNAL REVENUE [Key] 570

Where physician irrevocably deeded building in which he had offices to trustee for 20 years or death of both settlor and wife for benefit of wife and children and leased building from trustee for 10 years at reasonable rental, the rents paid trustee were deductible as a "business expense" from gross income in determining taxable income. 26 U.S.C.A. Int.Rev.Code, § 23(a)(1)(A).

See Words and Phrases, Permanent Edition, for all other definitions of "Business Expense".

Petition for Review of Decision of the Tax Court of the United States.

Petition by A. A. Skemp for review of a decision of the Tax Court of the United States, 8 T.C. 415, redetermining deficiency in the petitioner's income tax for 1941 imposed by the Commissioner of Internal Revenue.

Reversed.

T. H. Skemp and Q. H. Hale, both of La Cross, Wis., for petitioner.

Thereon Lamar Caudle, Asst. Atty. Gen., Sewall Key, George A. Stinson and Melva M. Graney, Sp. Assts. to the Atty. Gen., and Charles Oliphant and John W. Smith, both of Washington, D. C., for respondent.

Before KERNER and MINTON, Circuit Judges, and LINDLEY, District Judge.

MINTON, Circuit Judge.

The petitioner seeks the review of a decision of the Tax Court affirming a determination by the Commissioner of a deficiency in the petitioner's income tax for the year 1941 because of the disallowance as a business expense of $3,800 rent paid by him to the trustee he had named in a trust created by him.

The petitioner, hereafter referred to as the taxpayer, is a practicing physician in La Crosse County, Wisconsin. Prior to May 12, 1941, he owned a two-story brick building in La Crosse, in part of which he conducted his medical clinic and the rest of which was arranged for rental to other persons for general office purposes. On May 12, he created a trust for the benefit of his wife and children by conveying this building to the La Crosse Trust Company as sole trustee. The taxpayer is not in any way connected with this company as stockholder, officer, or employee.

By the terms of the trust agreement, the trust was made irrevocable and of twenty years duration unless

the settlor and his wife were both to die, whereupon the trust would terminate upon a specified event. Upon the termination of the trust, the property was to be distributed among the settlor's children. The taxpayer retained no significant control over the trust but did reserve the right to rent all or a part of the building "at a rental to be determined by the trustee." It is maintained by the taxpayer, and not denied by the Commissioner, that the trust agreement complied with all the laws of Wisconsin and is a valid trust thereunder.

On the same day as the creation of the trust, the trustee and the taxpayer entered into a lease which granted the entire premises to the taxpayer for a term of ten years. The rent for the first two years was to be $500 per month, and thereafter, in the event of disagreement, was to be fixed by a specified arbiter. The Commissioner does not contend that this sum of $500 is unreasonable. The taxpayer has paid this sum according to the lease, and the trustee has paid this income to the taxpayer's wife as beneficiary by depositing the sums in her separate checking account. In his 1941 income tax return, the taxpayer deducted these monthly payments of $500 under Sec. 23(a)(1)(A) of the Internal Revenue Code, 26 U.S.C.A. Int. Rev.Code, § 23(a)(1)(A). The Commissioner disallowed these deductions and the Tax Court sustained the Commissioner. It is this judgment that is sought to be reviewed.

The issue before us is the narrow one of deduction and does not involve the taxability of the trust income

under Helvering v. Clifford, 309 U.S. 331, 60 S.Ct. 554, 84 L.Ed. 788. The pertinent Internal Revenue Code section provides:

"Sec. 23. Deductions from gross income.

"In computing net income there shall be allowed as deductions:

"(a) Expenses.

"(1) Trade or business expenses.

"(A) In general.

"All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including * * * rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity." 26 U.S.C.A. Int.Rev.Code, § 23(a)(1)(A).

Payments of rent are thus specifically included in the statute as deductions. Unless we are to impute to the trustee a violation of its fiduciary duty, the taxpayer is "required" to pay these monthly sums—they are a legal and collectible obligation. Without further imputing such violation to the trustee, we cannot say that the taxpayer must not pay them "as a condition to the continued use or possession." There is no basis in the facts for such imputations, and the Tax Court's conclusion that the payments of rent were gratuities is mistaken.

The Tax Court also "concluded" that the amount of the rent is fixed by the taxpayer. As a legal interpre-

tation of the transaction involved, this conclusion is erroneous; nor is a finding to this effect supported by the record.

The Commissioner argues that the payments as rent were not required because the taxpayer had voluntarily entered into the transaction. While the taxpayer voluntarily created the situation which required the payments of rent, the fact remains that the situation created did require the payments. In this case we have a valid, irrevocable trust, wholly divesting the taxpayer of any interest in the trust property, and an agreement by the taxpayer to pay the trustee a reasonable rental under a valid lease. The income from the property is not claimed in this proceeding to be that of the taxpayer. We have here only a question of deduction of rental from gross income. There can be no question but what rent required to be paid is properly deductible. The trustee was duty bound to exact rent of the taxpayer and the taxpayer was legally bound to pay it, just as much as if the taxpayer had moved across the street into the property of a third party. No one doubts that he would have had to pay rent then, and would have been entitled to deduct it even though he had voluntarily created that situation. We are not impressed with the argument of the Government that the taxpayer voluntarily created the present situation.

Nor can we agree with the Commissioner's contention that there was no change in the taxpayer's economic status. He had irrevocably divested himself of all title and right to the property and could occupy it

only upon payment of rent, the amount of which was to be fixed by the trustee. In these circumstances, the fact that the payments of rent as trust income went to the taxpayer's wife is not material. This income went into the wife's individual bank account, and, of course, is her separate property. She had always been privileged to write checks on the taxpayer's bank account and had continued this practice without restraint after the creation of the trust.

Contrary to the Tax Court, we hold that this case does not fall within the ambit of *Johnson v. Commissioner*, 2 Cir., 86 F.2d 710. The facts are, of course, clearly distinguishable and as indicated above, this transaction involved substance, while that of the *Johnson* case was a formal sham.

The judgment of the Tax Court is reversed.